Office of Chief Counsel
Internal Revenue Service

memorandum

CC:LM:RFPH:CHI:1:POSTF-107937-02
JMCascino

date: June 14, 2002

to: Stanley W. Bantner, Group 1722
LMSB:HMT:Springfield, IL

from: Area Counsel
(Retailers, Food, Pharmaceuticals & Health Care)

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subject: [redacted] **("Taxpayer")**
TIN [redacted]
Taxable Years [redacted]
Worthless Stock Deduction
Request for Advisory Opinion

By memorandum dated April 22, 2002, we responded to your written request for advice in the above-entitled case which we received on April 4, 2002. In our memorandum dated April 22, 2002, we indicated that our advice was subject to National Office review and that you should take no action on the advice contained until such time as we notify you as to whether or not there are any exceptions or modifications to our advice by the National Office.

As we have already indicated to you over the phone, the National Office has recommended that we modify our previous advice to you in this case. As you know you have proposed to disallow the Taxpayer's worthless stock deduction in the amount of $[redacted] claimed with respect to its [redacted] ("[redacted]") common stock on its U.S. Corporation Income Tax Return (Form 1120) for the taxable year ended December 31, [redacted] on the ground that the Taxpayer's purchase of the [redacted] common stock was in substance a step in the Taxpayer's subsequent purchase of the assets of [redacted] through the proceedings in Bankruptcy Court. In our memorandum dated April 22, 2002, we recommended that you disallow the Taxpayer's claimed worthless stock deduction as proposed, [redacted], (b)(5)(AC)

(b)(5)(AC)

(b)(5)(AC)

As you know, the Taxpayer's worthless stock deduction in the total amount of $ for the cost of the 's shares included $ for and $ for . Unlike the stock which was directly purchased by from the shareholders for $ cash,

[redacted] obtained its stock by foreclosure on the promissory note from [redacted] ("[redacted]"). With respect to the $[redacted] portion of the worthless stock deduction claimed by the Taxpayer on behalf [redacted], we previously recommended that you should include an alternative determination that the Taxpayer did not establish its basis in the [redacted] stock.

By email dated June 11, 2002, you have submitted a new proposed Form 5701 for review in which you have determined that the $[redacted] portion of the worthless stock deduction claimed by the Taxpayer on behalf [redacted] should be disallowed because the Taxpayer has failed to establish it had any basis in the [redacted] stock. You also have determined that the Taxpayer is not entitled to a bad debt deduction. Based upon our review of the facts set forth in the proposed Form 5701 and your statement of the Taxpayer's position, we agree with your determinations that the Taxpayer has thus far failed to establish any basis in the [redacted] stock and failed to establish entitlement to any bad debt deduction.

In reviewing the new proposed Form 5701, we note that you state the issue as, "Whether the taxpayer is allowed to transfer basis from Note Receivable to Stock Investment". We recommend that the issue be stated as, "Whether the Taxpayer is entitled to a worthless stock deduction in the amount of $[redacted] for [redacted] stock owned by [redacted] as claimed on the Taxpayer's [redacted] return."

In reviewing the new proposed Form 5701, we note that you begin your "Law and Argument" section with a discussion of the legal requirements for a bad debt deduction. Since the Taxpayer has not claimed a bad debt deduction and your primary reason for the disallowance of the worthless stock deduction is the Taxpayer's failure to establish its basis in the [redacted] stock, we recommend that you begin your Law and Argument section with a discussion of the legal requirements for a worthless stock deduction. In this regard we recommend that you include the following discussion in your Law and Argument section:

Law and Argument

Section 165 provides:

(a) GENERAL RULE.--There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

(b) For purposes of subsection (a), the basis for determining the amount of the deduction for any loss shall be the adjusted basis provided in section 1011 for determining the loss from the sale or other disposition of property.

Section 165(g) provides:

(1) GENERAL RULE.--If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

Section 165(g)(2)(A) provides that the term "security" includes a share of stock in a corporation.

Treasury Regulation § 1.165-1(b) provides:

Nature of loss allowable. To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events and...actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

In order to obtain a deduction under Section 165(g), the taxpayer has the burden of showing: (1) that the security had a basis; (2) that the security was not worthless prior to the year in which worthlessness is being claimed; and (3) that the security became worthless in the year claimed. If a taxpayer acquires property by releasing a debt owed to the taxpayer, the taxpayer's cost basis in the property equals its fair market value. Bennett v. Commissioner, 139 F.2d 961 (8th Cir 1944); W.D. Haden Co. v. Commissioner, 165 F. 2d 588 (5th Cir. 1948); Megargel v. Commissioner, 3 T.C. 238, 248 (1944); Vadner v. Commissioner, T.C. Memo 1955-218; and H. O. Canfield Co. v. Commissioner, 9 T.C.M. 967 (1950). In this regard, Treasury Regulation § 1.166-6(c) provides that if a creditor sells mortgaged or pledged property, the basis for determining gain or loss upon the sale is the fair market value of the property at the date of acquisition by the creditor. Treasury Regulation § 1.166-6(a)(1) provides that if mortgaged or

pledged property is sold for less than the amount of the debt, and the portion of the indebtedness remaining unsatisfied after the sale is wholly or partially uncollectible, the mortgagee or pledgee may deduct the wholly or partially uncollectible amount under Section 166(a).

In this case, the aforementioned facts indicate that the [redacted] stock was worthless at the time acquired by the Taxpayer in [redacted]. These facts include, but are not limited to:

1) [redacted][1]

2) [redacted].

3) [redacted]

4) (Add any additional facts you think are relevant)

Accordingly, it is determined that the [redacted] stock acquired by [redacted] from [redacted] was worthless at the time of acquisition, the Taxpayer's basis in said stock is [redacted], no bona fide loss was sustained and the Taxpayer's claimed worthless stock deduction in the amount of $[redacted] is disallowed in full.

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[1] Your Statement of Facts at page 3 skips from a reference to Exhibit D to Exhibit F. You should insert a reference to Exhibit E or relabel your exhibits.

[redacted].

The Taxpayer maintains that the fair market value of the [redacted] stock was equal to the amount of the debt. The Taxpayer argues that [redacted] could have blocked the sale. However, at the time of the foreclosure on the debt, [redacted], the Taxpayer and the Unsecured Creditors Committee had already agreed in writing to a sale of [redacted]'s asset for less than the amount of the debt. We recommend that you further inquire of the Taxpayer as to how [redacted] could have blocked the sale after the Term Sheet had already been agreed to by the parties to the bankruptcy proceeding. If the Taxpayer can establish that, at the time of the foreclosure, [redacted] could have blocked the sale, you should then inquire as how the Taxpayer can maintain that the [redacted] stock was worth $[redacted] when the liabilities of [redacted] exceeded its assets by approximately $[redacted].

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions concerning this matter, please do not hesitate to call Attorney James M. Cascino at (312) 886-9225 ext. 338.

PAMELA V. GIBSON
Associate Area Counsel
(Large and Mid-Size Business)

By: James M Cascino
JAMES M. CASCINO
Attorney

Office of Chief Counsel
Internal Revenue Service

memorandum

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subject: [redacted] **("Taxpayer")**
TIN [redacted]
Taxable Years [redacted]
Worthless Stock Deduction
Request for Advisory Opinion

This memorandum responds to your written request for advice which we received on April 4, 2002. The advice rendered in this memorandum is conditioned on the accuracy of the facts presented to us.

This advice is subject to National Office review. We will contact you within two weeks of the date of this memorandum to discuss the National Office's comments, if any, about this advice. This memorandum should not be cited as precedent. We have coordinated this matter with Mergers and Acquisition Industry Counsel Lawrence L. Davidow.

ISSUES

1. Under the facts as set forth below, whether you should determine that the Taxpayer is not entitled to the worthless stock deduction in the amount of $[redacted] claimed with respect to its [redacted] ("[redacted]") common stock on its U.S. Corporation Income Tax Return (Form 1120) for the taxable year ended December 31, [redacted].

CONCLUSION

1. Under the facts as set forth below, we recommend that you should determine that the Taxpayer is not entitled to the worthless stock deduction in the amount of $[redacted] claimed with respect to its [redacted] common stock on its U.S. Corporation

Income Tax Return (Form 1120) for the taxable year ended December 31, [redacted].

FACTS

The facts as stated in your memorandum dated April 4, 2002 are incorporated herein by reference. The following is a summary of those facts.

Taxpayer is a [redacted] is the common parent of the Taxpayer. [redacted] and [redacted] are affiliated companies of [redacted] and members of the Taxpayer's consolidated group for the taxable year in question. [redacted]. The Company's primary materials utilized in the manufacturing process are [redacted], which are obtained from a broad base of suppliers.

[redacted] ("[redacted]") has been the president and CEO of [redacted] since [redacted].[1] [redacted] is also the CEO and president of [redacted] and [redacted].

[redacted] was the parent corporation of [redacted] (hereinafter [redacted] and [redacted] are collectively referred to as "[redacted]") and was not related to the Taxpayer. In or about [redacted], [redacted] became aware that the owners of [redacted] had put [redacted] up for sale. In a Memorandum to the Taxpayer's Board of Directors, [redacted] recommended that the Taxpayer make an offer to purchase [redacted] for the following reasons:

a. To increase the Taxpayer's capacity to make [redacted] by switching [redacted]'s production from [redacted];

b. Although [redacted] was losing large amounts of money, [redacted] thought the equipment was worth more than the investment

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[1] In your proposed report, you refer to [redacted] as "[redacted]". We recommend that you refer to him in a more formal manner such as "[redacted]", "[redacted]" or "[redacted]", etc.

that the Taxpayer would make; and

c. If the Taxpayer did not buy the stock, another buyer would.

On [redacted], [redacted] offered to purchase all of the [redacted] stock for $[redacted] per share. Because another buyer was also bidding for [redacted]'s stock, on [redacted], [redacted] increased its offer to $[redacted] per share. [redacted] eventually agreed to purchase approximately [redacted]% of [redacted] for $[redacted] per share. At that time, [redacted] had [redacted] shares of common stock issued, including [redacted] shares of treasury stock.

On or about [redacted], shareholders representing approximately [redacted]% ownership of [redacted] stock agreed to accept [redacted]'s offer to purchase [redacted]. The [redacted] decision date is based on a letter from [redacted] to [redacted] of [redacted] ("[redacted]"), dated [redacted], which stated: "[redacted]."

On [redacted], [redacted] assigned a right to purchase [redacted]% of [redacted] stock to [redacted] ("[redacted]"), while retaining the right to purchase [redacted]% of the [redacted] stock. [redacted] owned [redacted] of the stock of [redacted]. On [redacted], [redacted] executed a promissory note in the amount of $[redacted] in favor of [redacted]. The note recited that it was secured by a stock pledge agreement which was incorporated within the provisions of the note by reference. The stock pledge agreement recited that [redacted] pledged all its [redacted] shares to [redacted] to secure payment of the note and that the remedies of [redacted] under the stock pledge agreement were cumulative and non-exclusive. A letter from [redacted] vice-president [redacted] to [redacted]'s attorney states that the Taxpayer entered into the assignment to [redacted] in order that the Taxpayer would not have to include the losses of [redacted] in the Taxpayer's financial statements because it would own less than [redacted]% of [redacted].

On [redacted], [redacted] wire transferred $[redacted] from the [redacted] in [redacted] to the [redacted]. The wire transfer was deposited into an account titled "[redacted]", account number [redacted], for the purpose of purchasing the [redacted]% ownership in [redacted] stock. The Taxpayer identified $[redacted] of the total wire transfer as [redacted]'s loan to [redacted] and $[redacted] was identified as [redacted]'s stock purchase cost for [redacted]% ownership in [redacted]. In addition, $[redacted] was charged to "[redacted]." Additional amounts that

were capitalized to the cost of [redacted]'s purchase of [redacted] stock included amounts paid for stock options of $[redacted], legal fees of $[redacted] and $[redacted] for "[redacted]." These additional costs were charged to [redacted] and included as part of the Taxpayer's total cost in acquiring the [redacted]% ownership in [redacted].

[redacted] filed a voluntary Chapter 11 bankruptcy petition in the United States Bankruptcy Court for the [redacted] Division on [redacted]. The bankruptcy petition was signed by [redacted], CEO of [redacted]. On the Petition date, [redacted] was indebted to [redacted] ("[redacted]") pursuant to terms of the Amended and Restated Loan and Security Agreement dated [redacted], between Debtor and [redacted], with ("[redacted] Pre-Petition Loan Agreement") the principal amount (exclusive of interest, legal fees and other charges payable) of $[redacted]. There was an (estimated) balance sheet filed with the bankruptcy petition. However, in the "Monthly Operating Report" filed with the bankruptcy court, total assets as of [redacted] are listed as $[redacted]. Total Stockholder Equity as of [redacted] was a deficit $[redacted] (Ref #[redacted] Operating Report [redacted]).

[redacted] announced the acquisition of [redacted] percent ([redacted]%) of [redacted] effective [redacted]. [redacted] was the closing date for the purchase of the [redacted] stock by [redacted] ([redacted]%) and OTR ([redacted]%) (Ref - [redacted], [redacted]). On [redacted], the [redacted] board elected [redacted] as chairman of the Board, CEO and president of [redacted].

[redacted], the debtor, took on the identity of "Debtor- in-Possession". A creditors' committee was appointed after the Chapter 11 bankruptcy filing. The Committee consisted of [redacted] unsecured creditors.

The Taxpayer filed the Debtor's Plan of Reorganization on [redacted]. The Debtor's First Amended Plan of Reorganization was filed [redacted]. The Debtor's Second Amended Plan of Reorganization was filed [redacted]. On [redacted], the Taxpayer filed an "Amended Motion for Order to Authorize Auction of Substantially all Assets of Debtor. On [redacted], the Court issued an order to withdraw the Debtor in Possession Plan of Reorganization. On [redacted], and in response to a motion by the Debtor in Possession, the Court ordered a section 363 sale of "All Assets of the Estate" to [redacted]. On [redacted], the Taxpayer purchased the assets of [redacted] for an amount equal to [redacted]% of the secured debt and [redacted]% of the unsecured debt leaving no equity

for the common shareholders of [redacted] through a newly formed subsidiary of [redacted] named [redacted] of [redacted] ("[redacted]"). The Taxpayer estimated the purchase price of the assets in bankruptcy to be $[redacted]. During the bankruptcy proceeding, at least two buyers expressed interest in bidding on the assets of [redacted], but no persons other than the Taxpayer actually submitted a bid.

On [redacted], [redacted] filed UCC record #[redacted] with the [redacted] Secretary of State naming [redacted] as debtor and various assets of [redacted] as collateral. On [redacted], [redacted] filed UCC record #[redacted] with the Washington Secretary of State naming [redacted] as debtor and various assets of [redacted] as collateral.

When the first payment of interest on the loan from the [redacted] to [redacted] was due in or about [redacted], [redacted] defaulted and the [redacted] took ownership of the [redacted]% of [redacted] stock that the Taxpayer had previously assigned to [redacted]. There is no evidence that [redacted] made any attempt to collect on the note.

For [redacted] financial reporting purposes, the Taxpayer added the $[redacted] cost of the [redacted] stock to the $[redacted] estimated cost of the assets purchased in bankruptcy and allocated the total cost among the assets of [redacted]. The $[redacted] appears as Additional Paid In Capital on the balance sheet of [redacted] and as an "Other Investment" on the balance sheet of [redacted].
The Taxpayer has never written-off its investment in [redacted] stock for financial reporting purposes.

Although the Taxpayer has never written-off its investment in [redacted] stock for financial reporting purposes, on the Taxpayer's [redacted] Form 1120, the Taxpayer claimed a worthless stock deduction in the total amount of $[redacted] for the cost of the [redacted]'s shares including $[redacted] for [redacted] and $[redacted] for [redacted].
The worthless stock deduction of $[redacted] appears as a Schedule M item on the Taxpayer's [redacted] return.

In subsequent depositions taken during shareholder litigation, [redacted]

[redacted]

DISCUSSION

Section 165(a) provides:

> GENERAL RULE.--There shall be allowed as a deduction any loss sustained during the taxable year and not compensated for by insurance or otherwise.

Section 165(g) provides:

> (1) GENERAL RULE.--If any security which is a capital asset becomes worthless during the taxable year, the loss resulting therefrom shall, for purposes of this subtitle, be treated as a loss from the sale or exchange, on the last day of the taxable year, of a capital asset.

Section 165(g)(2)(A) provides that the term "security" includes a share of stock in a corporation.

Treasury Regulation § 1.165-1(b) provides:

> Nature of loss allowable. To be allowable as a deduction under section 165(a), a loss must be evidenced by closed and completed transactions, fixed by identifiable events and...actually sustained during the taxable year. Only a bona fide loss is allowable. Substance and not mere form shall govern in determining a deductible loss.

In order to obtain a deduction under Section 165(g), the taxpayer has the burden of showing: (1) that the security had a basis; (2) that the security was not worthless prior to the year in which worthlessness is being claimed; and (3) that the security became worthless in the year claimed. Based upon the facts as you have presented them to us, we agree with your determination that the Taxpayer has failed to establish that its "stock investment" in [redacted] became worthless during the taxable year [redacted].

First, we agree that you should include in your report a

determination that the Taxpayer has failed to establish that the [redacted] stock had any value at the time the stock was purchased by the Taxpayer. The facts indicate that [redacted] was suffering severe losses and had just filed a Chapter 11 bankruptcy petition which indicated that [redacted]'s liabilities exceeded its assets by $[redacted]. We believe that these facts indicate that [redacted]'s stock may have been worthless at the time of the Taxpayer's purchase. However, we recognize that whether the [redacted] stock was worthless at the time of purchase depends upon an analysis of all the facts and circumstances and that the mere existence of losses, balance sheet insolvency and the filing of a Chapter 11 bankruptcy petition do not necessarily establish that [redacted]'s stock was worthless at the time of purchase. Morton v. Commissioner, 38 B.T.A. 1270 (1938), aff'd 112 F. 2d 320 (7th Cir. 1940); Delk v. Commissioner, 113 F. 3d 984 (9th Cir. 1997); Osborne v. Commissioner, T.C. Memo 1995-353. The fact that the Taxpayer was required to raise its bid for the stock several times because of the existence of another bidder presents a significant hazard of litigation that the [redacted] stock had value at the time of the Taxpayer's purchase during the taxable year [redacted].

Even if the Taxpayer can establish that the [redacted] stock had value at the time of purchase, you have determined that the Taxpayer purchased the [redacted] stock merely as a first step in the Taxpayer's intended subsequent purchase of the assets through the bankruptcy proceeding. Accordingly, you have determined that the Taxpayer's worthless stock deduction should be disallowed because the Taxpayer's purchase of the stock should be treated, in substance, as part of its subsequent purchase of the assets. In your report, you rely on several cases in support of your position that the Taxpayer's purchase of [redacted] stock should be treated as a first step in its subsequent purchase of the assets in the bankruptcy proceeding. United States v. M.O.J. Corporation, 274 F. 2d 713 (5th Cir. 1960); Georgia-Pacific Corporation v. United States, 264 F. 2d 161 (5th Cir. 1959) and Commissioner v. Ashland Oil & Refining Co. v. Commissioner, 88 F. 2d 588 (6th Cir. 1938). These cases hold that,

> when stock in a corporation is purchased for the purpose and with the intent of acquiring its underlying assets and that purpose continues until the assets are taken over, no independent significance taxwise attaches to the several steps of multiple step transaction. The final step is, therefore, viewed not as independent of the stock purchase but simply as one of the steps in a unitary transaction, the purchase of asset. Georgia Pacific Corporation, supra. at 163.

This principle is known as the Kimbell-Diamond doctrine. The Taxpayer argues that the Service has stated in Revenue Rulings 90-95 and 2001-46 that Section 338 was "intended to replace any nonstatutory treatment of a stock purchase as an asset purchase under the Kimbell-Diamond doctrine." H.R. Conf. Rep. No. 760, 97th Cong., 2d Sess. 536 (1982), 1982-2 C.B. 600, 632. See Rev. Rul. 90-95, 1990-2 C.B. 67, 68 and Rev. Rul. 2001-46, 2001 I.R.B. 321. Therefore, the Taxpayer argues that Section 338 forecloses the Service from arguing in this case that the Taxpayer's purchase of [redacted] stock be treated as an asset purchase. Although the Kimbell-Diamond doctrine has been superseded by Section 338, Section 338 is not applicable in this case because the Taxpayer only purchased [redacted]% of the [redacted] rather than [redacted]% as required for the application of Section 338.

The following three tests have been used by the Courts to determine whether to apply the step transaction doctrine:

(1) End Result Test - Under this test, separate transactions are amalgamated when it appears they are really components of a single transaction and that each of the steps was intended to be taken for the purpose of reaching a specific end result.

(2) Mutual Interdependence Test - Under this test, the courts consider whether the steps are so interdependent that the legal relationships created by one transaction would be fruitless without the completion of the entire series of transactions. Unlike the end result test, the mutual interdependence test focuses on the relationship of the steps, not merely the end result.

(3) Binding Commitment Test - Under this test, a transaction will be aggregated with other transactions if there is a binding commitment to do the other transactions

McDonald's Restaurants of Illinois, Inc. v. Commissioner, 688 F 2d 520 (7th Cir. 1982); King Enterprises, Inc. v. United States, 418 F. 2d 511 (1969).

Because the Taxpayer's purchase of the [redacted] stock did not require the Taxpayer to purchase the assets of the Taxpayer, the "binding commitment test" is clearly not applicable in this case. However, under the "end result test", the facts set forth above indicate that the Taxpayer's purchase of the [redacted] stock was an initial step in the Taxpayer's intended purchase of Condere's assets. These facts include, but are not limited to, the following:

1. [redacted]'s memorandum to the Board of Directors indicates that:

a. [redacted].

b. [redacted].

c. [redacted].

d. [redacted].

2. In a deposition, [redacted].

3. After the Taxpayer acquired control of [redacted], the Taxpayer literally shut down the business of [redacted]. [redacted] inventory and receivables were substantially discounted and the Taxpayer did not provide warranty for the [redacted] manufactured by [redacted].

4. The Taxpayer utilized [redacted] to purchase [redacted]% of [redacted] in order to avoid having to include [redacted]'s losses on the Taxpayer's financial statements.

5. The Taxpayer has never written off its "stock investment" in [redacted] for financial reporting purposes.

Based upon the financial condition of [redacted] at the time of the Taxpayer's purchase of the stock, under the mutual interdependence test, the Taxpayer's purchase of the stock arguably would have been fruitless without the subsequent purchase of the assets. However, the fact that the Taxpayer's purchase of the assets had to be approved by the Bankruptcy Court presents a significant hazard of litigation with respect to application of the step transaction doctrine.

Treasury Regulation § 1.165-1(b) provides that a loss must actually be sustained during the taxable year, that only a bona fide loss is allowable and that substance and not mere form shall govern in determining a deductible loss. C.I.R. v. Fink, 483 U.S. 89 (1987). Here, while the Taxpayer in form purchased a "stock investment" in [redacted], the foregoing facts indicate that the Taxpayer did not purchase the stock with an intention to

derive dividends or capitals gains from its "stock investment" in the stock of [redacted]. The bankruptcy enabled the Taxpayer to renegotiate the union contract as well as pay unsecured creditors only [redacted]% of the amount owed by [redacted]. The Taxpayer's actions in shutting down the [redacted] plant indicate that the Taxpayer never intended to derive dividends or capital gains from its stock investment. The Taxpayer's use of [redacted] to purchase the stock of [redacted] also shows that the Taxpayer did not intend to hold [redacted] as a subsidiary because the Taxpayer did not want to be required to include the losses of [redacted] on its financial statements.

The fact that the Taxpayer has not written off its "stock investment" in [redacted] for financial reporting purposes also indicates that the Taxpayer never intended its purchase of [redacted] stock as a "stock investment". If the Taxpayer had, in substance, made an investment in the stock of [redacted], the Taxpayer should have written off this investment after the sale of assets in bankruptcy for [redacted]% of the non-secured debt rendered the stock worthless. Instead, the fact that the Taxpayer has never written off its "stock investment" in [redacted] indicates that the Taxpayer must have intended its "stock investment" as merely a step in its intended purchase of the assets of [redacted]. In addition, since the Taxpayer has not written off its "stock investment" in [redacted], the Taxpayer has not actually sustained a loss within the meaning of within the meaning of Treas. Reg. § 1.165-1(b).

We think the facts here are analogous to the facts in C.I.R. v. Fink, supra. In that case, the Supreme Court disallowed a loss claimed by a dominant shareholder on a surrender of a portion of its shares for the purpose of benefitting the corporation. The Supreme Court held that no economic loss had occurred and that the taxpayer had merely made a contribution to capital which should be allocated to the taxpayer's remaining shares. Here, the Taxpayer purchased the [redacted] stock as a step in its purchase of the assets of [redacted]. As such, the Taxpayer has suffered no economic loss upon the worthlessness of the stock as a "stock investment" and the cost of the stock should be added to the cost of the assets purchased in bankruptcy in the same manner the Taxpayer has treated the transaction for financial reporting purposes.

While we agree with your determination that the Taxpayer's loss should be disallowed because the Taxpayer did not in substance make a "stock investment" in [redacted] that became worthless during the taxable year [redacted], we note that there are hazards of litigation with respect to the Government's position. In particular, if the Taxpayer was able to produce credible

evidence that, at the time the Taxpayer purchased the [redacted] stock, the Taxpayer did not necessarily intend to liquidate [redacted] but intended to hold [redacted] as a potentially profitable subsidiary, the adjustment could probably not be sustained because the [redacted] stock essentially became worthless in the taxable year [redacted] when the Bankruptcy Court approved the sale of all of [redacted]'s assets for an amount equal to the secured debt plus [redacted]% of the unsecured leaving no value to the common shareholders. An interview of [redacted] with respect to his intentions at the time of the acquisition of the [redacted] stock would be useful in determining the intent of the Taxpayer. However, because the Taxpayer has yet to produce any credible evidence of an intention to profit from its purchase of [redacted] stock investment in the form of dividends or capital gains, we agree that the Taxpayer's claimed worthless stock deduction for its "stock investment" in [redacted] should be disallowed.

With respect to the $[redacted] portion of the worthless stock deduction claimed by the Taxpayer on behalf [redacted] Corporation, we recommend that you include an alternative determination that the Taxpayer did not establish its basis in the [redacted] stock. Unlike the [redacted] stock which was directly purchased by [redacted] from the [redacted] shareholders for $[redacted] cash, [redacted] obtained its stock by foreclosure on the promissory note from [redacted]. While the Taxpayer apparently stated that the stock was the sole source of payment, the promissory note on its face appears to be a recourse note and the stock pledge agreement states that [redacted]'s remedies thereunder were cumulative and nonexclusive. Despite the fact that [redacted] has UCC filings on the [redacted]'s assets with the states of [redacted] and [redacted], there is no evidence that the Taxpayer made any attempt to collect on [redacted]'s promissory note other than through the foreclosure of the [redacted] stock during [redacted]. Since the Bankruptcy Court already had ordered a section 363 sale of "All Assets of the Estate" to [redacted] of [redacted] on [redacted], the [redacted] stock (as a stock investment) was apparently worthless at the time the stock was acquired by [redacted] through the foreclosure during [redacted]. Since there is no evidence that the Taxpayer made any attempt to collect on the promissory note and the stock was apparently worthless when received, the Taxpayer has not established its basis in the [redacted] stock received through foreclosure on the note.

We recommend that you delete from your report your legal argument regarding Pre-petition vs. Post-petition costs. We do not believe that the cases and rulings which you have cited are on point, i.e., Palmer v. Commissioner, T.C. Memo. 1987-106;

Private Letter Ruling 9611028 and Revenue Ruling 74-9, 1974-1 C.B. 241. These cases and rulings indicate that the assets of the debtor became part of the bankruptcy estate upon the filing of the bankruptcy petition and that the basis of property reacquired by a taxpayer from a creditor or trustee in bankruptcy is the amount paid and not the taxpayer's basis in the property before the transfer to the creditor or trustee. In this case, the Taxpayer acquired [redacted]% of the stock of [redacted] from other shareholders of [redacted] and not from the bankruptcy estate. The fact that the Taxpayer completed its purchase of the stock after the bankruptcy petition was filed is some evidence that the stock may have been worthless at the time the stock was purchased. However, the filing of a Chapter 11 bankruptcy petition does not necessarily establish that the stock of the debtor is worthless. See Delk v. Commissioner, 113 F. 3d 984 (9th Cir. 1997); Osborne v. Commissioner, T.C. Memo 1995-353.

In accordance with the Chief Counsel Directives Manual, we are submitting this memorandum for review by our National Office and anticipate a response from the National Office in approximately ten days. As you know the response can supplement, modify and/or reject the advice contained herein. Accordingly, please take no action on the advice contained herein until such time as we notify you as to whether or not there are any exceptions or modifications to this advice by the National Office.

This writing may contain privileged information. Any unauthorized disclosure of this writing may have an adverse effect on privileges, such as the attorney client privilege. If disclosure becomes necessary, please contact this office for our views.

If you have any questions concerning this matter, please

do not hesitate to call Attorney James M. Cascino at (312) 886-9225 ext. (b)(7)c

PAMELA V. GIBSON
Associate Area Counsel
(Large and Mid-Size Business)

By:_____
JAMES M. CASCINO
Attorney

cc: James C. Lanning, Area Counsel
Harmon B. Dow, Associate Area Counsel (IP)
Pamela V. Gibson, Associate Area Counsel
William G. Merkle, Associate Area Counsel (SL)
Barbara B. Franklin, Senior Legal Counsel (HQ)
Lawrence L. Davidow, Industry Counsel